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Arizona Corporation Commission

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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION

IN THE MATTER OF COMPETITION)
IN THE PROVISION OF ELECTRIC)
SERVICES THROUGHOUT THE STATE)
OF ARIZONA)

Docket No. U-0000-94-165

COMMENTS OF PHELPS DODGE MORENCI, INC. IN RESPONSE TO
COMMENTS BY ELECTRIC COOPERATIVES AND ELECTRIC UTILITIES

Phelps Dodge Morenci, Inc. ("Phelps Dodge") is one of Arizona's largest consumers of electricity. In 1995, Phelps Dodge paid in excess of \$60 million for electricity for its Morenci, Arizona operation. As a major consumer of electric power, Phelps Dodge has a strong interest in proposals to allow competition in the electric power industry.

Phelps Dodge is one of 100,000 electric power consumers of Arizona rural electric cooperatives that could be denied access to lower-cost electric power if the comments of Arizona Electric Power Cooperative, Inc., Duncan Valley Electric cooperative, Inc., Graham County Electric Cooperative, Inc. and Sulphur Springs Valley Cooperatives, Inc. (collectively "electric cooperative entities" or "coop entities") are accepted by the Commission. Additionally, as with all Arizona consumers, Phelps Dodge will be adversely affected by higher than necessary prices and unjustified delays if the comments of the other electric utilities (such as those of SRP, APS and Tucson Electric Power Co.) are accepted by the Commission. Accordingly, Phelps Dodge offers the following response to some of the arguments made by both the electric cooperative entities and the other electric utilities.

...

1 **1. The Commission Should Not Exempt Electric Cooperatives From Competition.**

2 While the electric cooperatives pay lip service to support for competition, at root, they
3 request that the 100,000 customers of Arizona electric cooperatives be denied the benefits of
4 competition. This is bad public policy. Excluding cooperatives from competition would create
5 large transmission islands of absolute monopolies within Arizona, stifling the public interest of
6 providing lower cost electricity to consumers. The purpose of both the Rural Electrification Act
7 and the Rural Electrification Loan Restructuring Act of 1993 was to ensure that rural electric power
8 consumers enjoy dependable and low-cost electricity. The electric cooperative entities, however,
9 would now have this Commission turn this purpose on its head: They all rely on the federal
10 government's historic role in rural electrification as a justification for preventing electric utility
11 customers from receiving the lowest possible price for electricity. Simply put, if the electric
12 cooperative entities get their way, rural consumers will be the only consumers in Arizona prohibited
13 from purchasing low-price electricity. Rather than acting to lower electrical costs, the entities seek
14 this Commission to allow the rural cooperatives to maintain monopolies that will charge above-
15 market rates for electricity.

16 On behalf of itself and the 100,000 other residential and industrial customers of rural electric
17 cooperatives, Phelps Dodge urges the Commission not to exempt cooperatives from or delay
18 subjecting cooperatives to the Commission's electric competition rules. In evaluating the comments
19 of the electric cooperative entities, this Commission should focus on what is in the best interests
20 of electric consumers, rather than the often artificial and contrived institutional interests of the
21 cooperatives themselves. Indeed, none of the specific comments of the electric cooperative entities
22 justify exempting cooperatives from competition.

23 First, the coop entities claim that restructuring threatens the federal tax exempt status of
24 AEPCO and Arizona's distribution rural electric cooperatives. The proposed rules more than
25 adequately deal with this concern by establishing a waiver mechanism that permits cooperatives to
26 petition the commission to modify the schedule "so as to preserve the tax exempt status of the

1 cooperatives." Proposed Rule R14-2-1604.H. In any event, the coop entities have not
2 demonstrated either (i) that any electric cooperative would actually lose their tax exempt status or
3 (ii) that the cooperatives could not restructure to prevent the loss of the tax exempt status. At best,
4 the entities offer speculation that is belied by both the facts and common sense. For example, it
5 would appear that cooperative bylaws could be amended to establish different classes of
6 membership so that a third-party power supplier or marketer could simply become a member of the
7 cooperative. Consequently, any transmission fees paid by such a member to the cooperative would
8 be considered revenues from members and would not run afoul of the 15% requirement.
9 Interestingly, the State's only operation and transmission cooperative, Arizona Electric Power
10 Cooperative, Inc., has utilized precisely this structure to create different classes of membership so
11 that revenues derived from the City of Mesa (a Class B member) and Salt River Project (a Class
12 C member) are member revenues for federal income tax purposes.

13 More fundamentally, the electric cooperative entities fail to explain why the loss of tax
14 exempt status will necessarily harm its member consumers. Whether or not the loss of tax-exempt
15 status will result in a large corporate tax depends on the operation of the cooperative. If
16 cooperatives continue to operate on a break-even basis, any tax will be de minimis. Moreover,
17 even if the cooperatives pay a tax, consumers may still be better off because they would have
18 access to less expensive electricity.

19 Second, the coop entities argue that they should be exempt from competition because they
20 owe debt to the federal government. Specifically, they contend that the proposed rules could cause
21 a default of their obligations to the federal government because these obligations purportedly require
22 the cooperatives to have an exclusive service territory. Of course, should these loans become a
23 problem, the proposed rules allow cooperatives to petition for a modification of the schedule "to
24 allow time to modify contractual arrangements pertaining to delivery of power supplies and
25 associated loans." Proposed Rule R14-2-1604.H. In our view, however, this debt hardly supports
26 delaying the benefits of competition.

1 Electric cooperatives are hardly unique in owing debt--virtually all electrical utilities owe
2 debt. As with the cooperative's debt, lenders advanced funds to electric utilities at a time when
3 the utilities were regulated monopolies with an exclusive service area. The fact that the
4 cooperatives' debt is from the federal government rather than from private sources hardly justifies
5 denying rural cooperative customers--but not customers of other utilities--the opportunity to
6 purchase low cost electricity.

7 Third, the coop entities argue that the draft rules would require that the federally supported
8 cooperatives' facilities be made available to companies that are not the intended beneficiaries of the
9 Rural Electrification Act. RUS regulations do not preclude such use of RUS-funded facilities as
10 long as the primary purpose of the loans remains to furnish or improve service to intended
11 beneficiaries. That test would be satisfied here--regardless of who generates the electric power,
12 the ultimate consumer of the electric power transmitted over cooperative facilities will be the
13 existing cooperative members/consumers.

14 Fourth, the coop entities argue that cooperatives should be exempt from the proposed
15 regulations because municipalities are excluded. This ignores that municipalities are exempted only
16 because the Commission lacks jurisdiction over municipalities--not because of any reasons of public
17 policy. Cooperatives, on the other hand, are public service corporations over which the
18 Commission exercises plenary rate making and general service jurisdiction. Moreover, rural
19 electric cooperatives play a far larger role in providing transmission services in Arizona than do
20 municipalities. Accordingly, the inclusion of rural cooperatives is more important to the success
21 of statewide electric competition. Exempting rural cooperatives would create islands of monopoly
22 that could stifle transmission of competitive electricity to other Arizona consumers.

23 **2. The Commission Should Reject the Treatment of Stranded Costs Suggested by**
24 **Both the Electric Cooperatives and the Electric Utilities**

25 Most of the comments of the electric utilities have criticized the proposed rules regarding
26 stranded costs. In our view, this criticism is misplaced. The proposed rules recognize the

1 complexity of the stranded cost issue, and appropriately establish a working group to resolve this
2 complex issue. Phelps Dodge offers the following principles that should guide treatment of this
3 issue. With a few exceptions--noted below--the proposed rules are consistent with these principles.

4 The subject of alleged "stranded costs" has been intensely debated as the electric industry
5 moves toward competition. The debate has focused on many issues, including the basic questions
6 of whether stranded costs even exist at all and, if so, how those costs should be calculated,
7 recovered and from whom they should be recovered. At this point, stranded costs are conceptual
8 estimates that depend primarily on forecasts about what the future will bring in the electric power
9 industry. At a minimum, great uncertainty surrounds this issue.¹

10 The question of recovery of stranded costs should be addressed only after determining
11 whether a particular utility may legitimately suffer from the existence of costs claimed as stranded.
12 The determination of claimed stranded costs must proceed at the local level on a utility-by-utility
13 basis. First, at a minimum, utilities must bear the results of decisions that were not reasonable or
14 prudent. Second, any policy of total recovery of reasonable and prudent stranded costs from
15 customers could impede the move to competition because--depending on the recovery mechanism--
16 customers may actually incur increased power costs by switching power providers. Thus, the
17 amount of stranded costs that should be imposed on customers must not exceed a level that would
18 prevent them from enjoying the benefits of competition. And all players in the marketplace--
19 utilities, marketers, brokers, etc.--should contribute to the recovery of those costs. Third, any
20 recovery of stranded costs must be on a "net" basis. Any benefits that a utility receives because
21 of competition ("stranded benefits") must be subtracted from stranded costs. Otherwise stranded
22 cost recovery will be nothing but a windfall for utilities. Potential benefits include increased
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25 ¹ The Commission should be skeptical of utility claims of large stranded costs. Utility stocks
26 are now selling at multiples of book value, strongly suggesting that the current rate regulation has
more than compensated utility shareholders for utility investments.

1 wholesale and additional retail sales, development of new services or business opportunities and the
2 appreciation of some assets.

3 Additionally, the Commission should develop policies to require utilities to mitigate the
4 impact of any costs claimed to be stranded. Obviously a policy of absolute recovery by a utility
5 of all of its stranded costs is dead wrong because it would eliminate any incentive for the utility to
6 mitigate those costs. Moreover, before a utility can recover any stranded costs, it should be
7 required to prove that it has mitigated the impact of the transition to competition to the fullest extent
8 possible, beginning as of the date the possibility of competition was made clear. Indeed,
9 competition in electrical energy is incorporated in the Energy Policy Act of 1992. Accordingly,
10 any utility investment decisions made after this Act should not be included in any determination of
11 stranded investment.

12 Stranded costs undoubtedly will vary from utility to utility. Similarly, a customer's
13 obligation to pay for stranded costs, if any, will vary from customer to customer. Use of a simple
14 formulaic method for determining and assessing stranded costs could unfairly punish certain
15 customers while benefiting utilities. Before any stranded costs are imposed, an evidentiary
16 proceeding concerning the existence, reasonableness, prudence and mitigation of those costs must
17 occur. This procedure will be a particularly fact intensive inquiry. Utility customers must have
18 an opportunity at such a proceeding to present evidence concerning whether they should bear any
19 portion of stranded costs.

20 As a result of such evidentiary proceedings, stranded costs, to the extent they are
21 determinable and recoverable, should only be imposed upon customers in those circumstances
22 where the utility has made an investment to serve the customer, but the customer has not paid for
23 that investment. Numerous situations exist where it would not be fair or proper to impose stranded
24 costs on a customer, even if that customer is leaving a utility's system. For example, large
25 industrial customers often pay for a utility's investment in the source of power for the customer
26 (such as a power plant or wholesale power requirements contract) through the terms of a power

1 contract or through the applicable rate structure. A power contract between a large industrial
2 customer and a utility usually contains a demand charge or rate as well as an energy charge. A
3 take-or-pay demand charge in such a contract is designed to insure that the utility will have an
4 opportunity to recover the capital costs incurred to serve that customer over the term of the
5 agreement. Over the course of the power contract, the customer basically pays for the plant needed
6 to meet the demand. Only an energy rate is based upon variable-cost recovery. That rate is driven
7 by the cost of fuel, purchased power and other variable costs of providing the energy actual
8 consumed by the customer. Thus, over the course of a long-term power contract, a large industrial
9 customer may repay a utility's entire capital cost (or more) of the facilities used by the utility to
10 provide service to that customer. To require a customer who over time has essentially paid for the
11 facilities that provide its power to also pay a portion of the utility's overall stranded costs would
12 be punitive and would result in a financial windfall for the utility. An evidentiary proceeding will
13 prevent utilities from gaining such windfalls or customers from bearing an unfair portion of such
14 claimed stranded costs. Unfortunately, the proposed rules do not explicitly embrace such a
15 customer-by-customer approach to stranded costs.

16 **3. Calls For Further Delay Should Be Ignored**

17 Some commenters urge further delays before competition is allowed in this industry. The
18 asserted basis for this delay is the need to resolve issues, such as stranded costs, before the rules
19 are finalized. These demands for delay are baseless. The Commission's proposed rules already
20 delay for years the benefits of competition for most consumers--most consumers would not benefit
21 from competition until the next century. Indeed, the timetable proposed by the Commission staff
22 would allow resolution of issues such as stranded costs well before any utility is obligated to allow
23 competition.

24 More importantly, the need for Arizona to go forward with competition is compelling. The
25 current economic basis for regulation of the sale of electricity to the public is based on the
26 assumption that the most efficient means of providing electric power is to allow electric utilities to

1 have monopolies, but subject these monopolies to extensive regulation. The evidence is clear,
2 however, that the generation of electricity is no longer a natural monopoly. As such, it is now time
3 to move to a new model of competition in this industry.

4 Phelps Dodge is convinced (and the history of economics demonstrates) that the result of
5 competition will be better service, lower prices, and increased efficiency. Illustratively, as a result
6 of competition in the long-distance telephone market, consumers now enjoy higher quality service
7 at about half the price offered by the former monopoly service provider.

8 These benefits of competition will have a large economic impact on businesses in Arizona,
9 and any delay in competition will undoubtedly discourage businesses from locating or expanding
10 operations in Arizona. Electric power costs make up a large percentage of the operational costs
11 of Phelps Dodge and other mining and industrial companies. Accordingly, electric power costs are
12 a primary consideration used by Phelps Dodge and other companies in deciding where to locate.
13 States that refuse to embrace competition will find themselves no longer attractive location sites.
14 Conversely, states that embrace competition on a quick time table will become very desirable places
15 to locate. Several states--including California--are already moving toward competition. Arizona
16 cannot allow itself to be left behind. We therefore support the prompt transition to competition that
17 is reflected in the proposed rules.

18 Conclusion


19 In conclusion, Phelps Dodge urges the Commission to adopt rules that will ensure all
20 Arizona electric consumers the opportunity to benefit from competition without delay. Arizona's
21 100,000 rural electric cooperative consumers should not be deprived of the benefits of competition.
22 Accordingly, the Commission should include rural electric cooperatives within the rules, and reject
23 the electric cooperative entities' and electric utilities' proposals to postpone bringing competition
24 to Arizona. The issue of alleged stranded cost recovery must be carefully analyzed on a utility
25 by utility basis giving due regard to the net benefits to a utility that competitive markets will bring.

26 . . .

1 In large measure, the proposed rules are consistent with the comments made by Phelps
2 Dodge. We therefore urge the Commission to adopt the proposed rules.
3 November 27, 1996.

4 Respectfully submitted,

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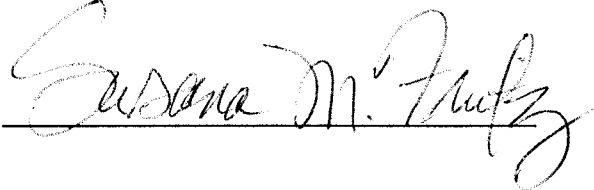
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